

A Rescue Plan for British Pensions

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This paper first looks at the failings of current pension provision and policy, in the light of new data and projections. It estimates that, with a quarter of the population over 65, pension needs by 2031 will be close to 16.8 per cent of GDP but that the existing pension regime cannot meet that target. It then explores ways in which the target sum could (almost) be furnished.

We live in an ageing society with a woefully inadequate pension regime. We lack convincing ways of addressing the future needs of a rapidly increasing population of over-60s and over-80s. Though they occasionally overdo it, the alarmism of the tabloids is closer to the mark than broadsheet complacency. The problem is more difficult to see if you are yourself part of the shrinking minority that belong to a good occupational scheme.

Another reason for complacency may be failure to see beyond the exceptionally favourable conjuncture of the last two decades. The proportion of the population over 60 did not change much between 1980 and 2000, and the stock market grew impressively over the same period. These circumstances did not furnish a stiff test of the adequacy of the pension regime – but the results were still disappointing, with problems of coverage, excessive cost and insecurity. The future will be far more demanding.

The Need to Think Big

The ageing effect is set to intensify. This is partly because the famous postwar baby-boomers will retire over this period but also because the new, higher levels of the elderly in the population will thereafter be maintained, because longevity is increasing and fertility quite low. In December 2003 the Government Actuaries Department (GAD) issued new projections which tell us that those over 60 will rise from 12.3 million in 2002, comprising 21 per cent of the total population, to 19.4 million in 2031, 30 per cent of the then total. (They believe that the UK's population will be 1.2 million higher in 2031 than they previously supposed and they have raised the projected life expectancy of 60 year olds by eighteen months. Life expectancy at birth will rise from today's 75.9 years to 81 years by 2031. Low birth rates make as great a contribution to the ageing effect as does increased longevity. The GAD estimates that women born after 1985 will have an

average of 1.74 children compared with an average of 2.45 children for women born in the 1930s.)¹

The average age of retirement for women workers today is 60 years, and for male workers 62 years. Women can claim the state pension today at 60 but this will rise by stages to reach the male pension age of 65 years by 2020. If this new pension age doesn't change then a quarter of the population will qualify by 2031. At that time 9 per cent of the total population will be over 80 years old, compared with 4 per cent today. At present one third of adults between 50 and the state pension age are outside employment, with most claiming either a disability benefit or income support. Let us assume - optimistically - that by 2031 the average age of withdrawal from the workforce will rise from 61 to 65, with early retirement balanced by those who work on into their late sixties. If that is achieved, then by 2031 about a quarter of the population are likely to be looking to public and private pension provision to sustain their income. At present pensioner incomes are a little above 70 per cent of average per capita disposable income. To maintain the same ratio and prevent a drop in pensioners' relative standard of living our various programmes of pension provision will have to generate pensions worth about 16.8 per cent of GDP.² Even if we vary the assumptions the need to think big remains because we are talking of the livelihood of so many fellow citizens.

The government, in what it calls a 'Partnership in Pensions', is planning to reduce the overall public contribution to retirement incomes and to raise the proportion of private pension provision to 60 per cent of the total by 2050.³ At present government spending on state pensions and related benefits comprises 4.8 per cent of GDP. The state pension, indexed to prices not earnings, is set to decline from 3.8 per cent of GDP today to 2.9 per cent by 2031 and 2.1 per cent by 2051. The State Second Pension, SERPS, and the Minimum Guaranteed Income (MIG) were to raise state support for pensioners from 4.8 per cent in 2000 to 4.6 per cent in 2031 and 4.1 per cent in 2051. Because the MIG was means tested some warned that it would penalise those with modest savings or pension entitlement. The government responded by introducing the Pension Credit, actually a complex benefit taper that leaves many pensioners still

¹ I would like to thank Lucinda Platt, Adair Turner, Diane Elson, Anthony King and others present at the Vice-Chancellor's Seminar at the University of Essex 8 March 2004 for helpful comments on an earlier draft; of course, they are not responsible for any mistakes or the particular conclusions I reach).

² The argument that generational justice requires us to strive to maintain the ratio of per capita pension income to average income is made by John Myles in 'A New Contract for the Elderly', in Gosta Esping-Andersen et al, eds., *Why We Need a New Welfare State*, Oxford 2002.

³ Secretary of State for Social Security, *A New Contract for Welfare: Partnership in Pensions*, Cm 41, December 1998., p. 103.

paying a high marginal tax rate. The Pension Credit involves means-testing those who apply for it but with results that allow them to keep more of their income from small savings than did the MIG. It is difficult to know exactly what impact the new Pension Credit will have – so far take up has been little more than a half of those who might qualify - but the DWP in its Green Paper on the topic forecast that it might boost public pension expenditure to 4.7 per cent in 2031 and 4.8 per cent in 2051. Pricewaterhouse-Coopers, assuming a higher future take-up, has raised the estimate so that government income support to the elderly rises to 5.3 per cent of GDP. If the government of 2031 is still paying a £200 annual winter fuel payment, and offering free TV licences to the over 75s, then government support for pensioners might reach 5.5 per cent of GDP, with the over-65s a quarter of the population.⁴

Staying with the earlier target figure that pensioners should receive overall 70 per cent of average income, and the government's aim that 60 per cent of this should come from private and occupational schemes, we see that occupational and personal pensions will have to supply about 11.5 per cent of GDP by 2031 and 14 per cent of GDP by 2051, most of which is to come from investment income from shares, bonds and other assets. These are extraordinarily ambitious targets.⁵ At the present time private provision is worth about 4.0 per cent of GDP though it absorbs more than this for future needs. While there is scope for more efficiency attaining over double the level of existing provision by voluntary means is an incredible goal.

State Pension Strategists Think Small

The hoped-for level of overall provision could be made a little less daunting by raising rather than lowering the contribution of public pensions. Indeed there is a strong case for raising levels of state provision immediately and planning for them to be considerably higher than in the government's projections.

Today's pensions are unequally distributed with much scope for raising the incomes of the poorest and some scope for curtailing subsidies enjoyed by the wealthiest. In 2001-2 the median income of the poorest fifth of pensioner couples was £155 a week, or £77.50 each, from all sources, while the median income of single pensioners was £87 a week. The next fifth of

⁴ Memorandum by PricewaterhouseCoopers, Select Committee on Economic Affairs, House of Lords, *Aspects of the Economics of an Ageing Population*, Volume II, *Evidence*, January 2004, p. 77.

⁵ It is worth bearing in mind that all 'property income' generated by corporations in 2002 amounted to £122 billion or a little over 12 per cent of GDP. *Monthly Digest of Statistics*, January 2004, p. 9.

pensioner couples received median incomes of £203, or £101.50 each, while single pensioners received £120. For some reason we tend to 'think small' - in weekly amounts, as with children's pocket money - when it comes to pensions. These figures meant that the poorer two fifths of pensioners were getting by on c. £4-6,000 a year.⁶ Even those in the middle had less than £7,000 a year. The single pensioner applying for the Pension Credit should now be entitled to a minimum of £5,309, with many at or close to this level.

The pensioners most likely to be in poverty are women, especially if divorced or separated from their husbands - 40 per cent of divorced or separated women over 65 were receiving income support in 2001-2, compared with 23 per cent of divorced or separated men over 65.⁷ Historical pension entitlement, whether public or private, was based on formal employment, and took no account of the huge amount of unpaid labour performed by women in domestic settings. In future the Second State Pension will offer modest credits for those with registered family responsibilities but this will scarcely match the huge contribution made by women of all ages to the care of children, elderly relatives and infirm spouses.⁸ One half of women of pension age do not receive the full state pension, mean as this is compared with public pensions elsewhere. If they fill in a complex and inquisitive form they can qualify for the Pension Credit but many who would meet the criteria fail to apply. Many older persons, especially women, will collect their basic state pension but are deterred by the means tests. Female pensioners are not properly covered by the state pension arrangements but their share of private and occupational provision is even weaker. Only 43 per cent of female pensioners have private provision and those with it receive an average of only £44 a week from it. Together with weaker state provision this leads to a situation where the median income of female pensioners from all sources was only £92 a week in 2001-2.⁹

The British state pension is currently worth only 15 per cent of average earnings and is scheduled to decline to less than 10 per cent over the next thirty years. The Pension Credit, the means-tested supplement, raises this to about 21 per cent of average earnings today, and will be pegged to earnings not prices. However, as we have seen, the government's intention is that state payments will make a steadily declining contribution to retirement income in coming decades.

⁶ Department of Work and Pensions, *Work and Pension Statistics*, 2003, p. 86. The top fifth of pensioner couples received median income of £510 a week, or £255 each, while single pensioners received £261 a week. There are much greater inequalities within this top quintile than in the others.

⁷ Sara Arber and Jay Ginn, 'Ageing and Gender', *Social Trends*, No 34, January 2004, p. 9.

⁸ *Social Trends*, 34, p. 10.

⁹ *Social Trends*, 34, p. 10.

This policy was laid out in *Partnership in Pensions* in 1998 and it informed legislation in the following year, including provision for so-called Stakeholder pensions. The aim here was to combine a means-tested safety net with a belief that those not enrolled in an occupational scheme could be persuaded to take out a Stakeholder or similar personal pension plan. Despite the fact that employers are obliged to offer Stakeholders to their employees the take up has not been strong – it reached 1.6 million by the end of 2003 – and many of those who have a Stakeholder are not the previously uncovered and/or low paid at whom the programme was aimed. In 2000-1 47 per cent of employees were enrolled in an occupational and 12 per cent had a personal pension plan. Only 2 per cent of the self-employed had an occupational scheme while 44 per cent had a personal plan.¹⁰ If those outside the labour force are taken into account then barely half the adult population have private pension coverage.

We know that the quality of pension coverage is very uneven. Job mobility means that many millions are dragging around a nominal pension entitlement that will not stand the test of time, because it was small, weakly indexed and/or not fully vested. For those who stick to the scheme until retirement the ‘defined benefit’ (DB) approach is much the best. Even then the DB regime still has major drawbacks, The pension promise is guaranteed only by the sponsoring company, which can get into difficulties or go bust. The DB pension scheme often grows to be more valuable than the company. When the dinosaur-like fund tail begins to wag the corporate dog this can be bad for all employees. The company is forced to mend deficits in its pension scheme rather than invest in the business, with a consequent loss of good jobs. This has happened at Rolls Royce, Corus, ICI, GKN and a host of famous companies. But at least DB schemes give priority to pensions. In recent years thousands of these schemes have been frozen or wound up, with employees invited to join ‘defined contribution’ (DC) schemes instead. Employer contributions have plummeted. Employers often used to contribute 12%-16% of salary to DB schemes but usually opt for a much more modest 3-6% for today’s DC schemes. DC schemes place the market risk on the employee not the employer. The collapse of the share bubble in 2000-2 and the secular decline in annuity rates have undercut personal pension plans of all types.

¹⁰ Alan Pickering, *A Simpler Way to Better Pensions: an Independent Report*, TSO, July 2002, p. 70. For figures drawn from an Amicus survey that found slightly worse coverage see Derek Simpson, ‘The Pension Thieves’, *The Guardian*, 11 March 2004. The weakness of provision was acknowledged in the DWP Green Paper, *Simplicity, Security and Choice: Working and Saving for Retirement*, Cmd 5677, December 2002, pp. 29, 51, but the main remedy, apart from some welcome simplifications, was still to urge people to save more within the framework set out in the earlier *Partnership for Pensions*. Despite yeoman service from the experts commissioned to supplement information contained in the Green Papers and DWP publications, the government has not invested serious resources in clarifying the deficit in pension wealth held by the population as a whole. Myners, Sadler and Pickering were expected to produce recommendations relying on their own expertise and with a negligible research budget.

Personal pension plans also continue to suffer from a ‘cost disease’, stemming from heavy marketing, the expense of customising provision to scattered individuals, and the scope given to a host of laxly-invigilated financial intermediaries, each of whom take their cut.

For a century and a half British Chancellors have given generous tax breaks to those investing in pensions - currently these foregone taxes are £19 billion a year or 1.9% of GDP. The saver will eventually receive 25 per cent of their ‘pot’ as a tax-free lump sum, the remainder being taxed at a lower rate in retirement than it would have been while the recipient was earning (so that the net tax relief is £13 billion¹¹). The incentives here are heavily weighted in favour of those paying at the upper tax rate of 40%. Those on average or below average earnings, paying tax at the 23% or less rate, have far less incentive to invest in a personal pension plan. The smaller plans of the lower paid will be more heavily eroded by commission and charges than the larger savings pots of higher earners, reflecting returns to scale in personal plans, the better paid workers’ access to low cost schemes and the start-up fees charged by independent financial advisers.

Personal indebtedness in Britain is now running at about 130 per cent of annual disposal income. Anyone servicing a credit card debt or a mortgage endowment policy should pay down their debt, if they can, rather than buy an inefficient pension product. Those who don’t own a home will often feel that this has priority over a pension plan and those without a car may feel that buying one would improve their employment prospects. Financial experts and advisers are prone to lament the ignorance or short-term horizons of those who fail to take up personal pension plans. But it could be that they have a better grasp of the matter than the experts. Research shows that fund charges reduce investment yields in pension plans by around 45 per cent.¹² Even the Stakeholder charge of 1 per cent of the pot annually - widely regarded as far too low by the savings industry - will reduce the eventual pot by about 20 per cent over forty years. It is not usually noted that this one per cent charge does not include the commission and renewal fees charged by Independent Financial Advisers. And the eventual pension that any given pot can buy has been nearly halved by the collapse of annuity rates over the last decade. These various reductions in yield nullify or absorb the modest tax relief which those earning less than £30,000 can claim.

¹¹ DWP, *Simplicity, Security and Choice*, p. 40.

¹² I survey this research in chapter 2 of *Banking on Death or Investing in Life: the History and Future of Pensions*, London 2002.

Those who are members of a good occupational scheme or who finance a personal plan from earnings of over £40,000 over a lengthy period are quite well served by our existing pension regime. Most of those in the top quintile of incomes, and many in the next richest quintile, can expect to replace at least a half of their former salary (bringing them well above 70 per cent of average income).

However, as we know, it is not plain sailing even for the middle class pensioner, whether member of an occupational scheme or beneficiary of a personal pension plan. Notwithstanding the recovery in share prices the estimated pension deficit of the major DB funds was £65 billion at the end of 2003. The new Pension Bill introduces an insurance scheme whereby companies must in future pay into a Pension Protection Fund, which will guarantee reduced payment levels to members of such schemes. The government is not, reasonably enough, putting any tax money towards this scheme. John Ralfe, a pension consultant, warns that it will either be affordable to companies but have too little resources or it will have enough resources but demand a level of contribution which will eat into company investment plans.¹³ The US equivalent, the Pension Benefit Guaranty Corporation (PBGC), is currently \$11.5 billion in the red; members of schemes it has insured usually suffer considerable reductions in the pay-out they will receive. Bankruptcy is not the only risk. In both the UK and US employees can sometimes lose entitlement when their company is sold or restructured (about 60,000 have lost out in this way in the UK over the last couple of years). At least these DB schemes have good cost ratios. Personal plans are more expensive and threatened by similar problems of supplier failure. The collapse of Equitable Life, affecting nearly a million savers, and the shortfalls faced by many 'with profits' plans illustrate the danger. The memory of the pension mis-selling scandal of the 1980s and 1990s, affecting three million pensioners, highlighted a cost burden that has not disappeared.

British pension funds of all types are worth about £850 billion – equivalent to about 90 per cent of GDP – and the fund managers have annual expense ratios equivalent to about 2 per cent of their assets. If we add in the costs of consultants and custodians, the invisible charges involved in 'soft commissions', together with the fees charged by Independent Financial advisers, overall expenses in the sector amount to at least 2 per cent of GDP. In a funded system there is, of course, no connection between incomings and outgoings at any given time, though in a mature system with good investment growth one might expect the former to overtake the latter. Yet when we examine the private sector contribution to actual pensioner incomes it seems to punch

below its weight. According to new, downwardly-revised figures, the pensions industry takes in £52 billion annually in contributions.¹⁴ It also receives a tax subsidy of more than £13 billion, so that its receipts are something like 6.5 per cent of GDP.¹⁵ Yet it pays out 4.0 per cent or less in pensions. While demography partly explains this, the costs generated by the financial services industry weaken the returns. (In the wake of the recent mutual fund scandals in the US John Bogle, former CEO of Vanguard, complained that that total costs of this component of the US savings industry were around \$130 billion annually, or 1.3 per cent of US GDP, a figure he thought needlessly inflated.¹⁶)

While it would be easy to enlarge upon the problems presented by the private savings industry - and also to show how the pension fund regime fosters irresponsible investment styles (churning bubbles, rapid trading, short termism, herding, indulgence of poor governance and so forth¹⁷) - I would like instead to return to the large problem set out at the beginning: How can we meet a dramatically larger pension bill? I would first like briefly to consider developments which some believe solve the problem because they would expand the contributor and tax base.

Liberalising Immigration, Retiring at 70 and Raising the Birth Rate

There is scope for raising the effective age of retirement by voluntary means (i.e. without further raising the state pension age). If discrimination was seriously tackled then many more 50-65 year olds would be able to get employment and many over-65s would decide to stay on. Bringing the average age of withdrawal from the labour market up to 65 would itself be a major achievement. Those who qualify for the state pension can continue in work, and either defer it (obtaining a better future pension) or add it to their earnings. This allows the older worker to maintain income but take a less demanding job.

¹³ Anthony Hilton, 'Pension Sums Don't Add up', *Evening Standard*, 20 February 2004. See also Philip Coggan, 'Safety net still has holes in it', *Financial Times*, 23 February 2004.

¹⁴ Ed Crooks and Nicholas Timmins, 'Official View of Size of Economy in Doubt', *Financial Times*, 31 January - 1 February 2004.

¹⁵ The DWP, basing itself on Eurostat, told the House of Lords enquiry that overall (state plus private) pension expenditure in the UK was 11.5 per cent of GDP in 1999 while public provision was 5 per cent of GDP. However it warned that one could not necessarily impute a private expenditure share because the figures are from different sources. House of Lords, Select Committee on Economic Affairs, *Aspects of the Economics of an Ageing Population*, II, *Evidence*, p. 23.

¹⁶ John C. Bogle, 'Not-So-Mutual Funds', *Wall Street Journal*, 14 November 2003.

¹⁷ I explore these issues in *Banking on Death*.

But raising the state pension age – as some propose - would be hard on manual workers, who, after a lifetime of contributions, die at younger ages than professionals and managers. If the state pension age is raised and many older persons fail to get a job, or apply for a disability benefit, then the savings made in state pension outlays will be counter-balanced by increased benefit expenditure. Because people stay fitter for longer, and if ageism can be tackled, there is scope for raising the number of years the over-60s work. But the gain here will be partly counter-balanced by the need to allow for the fact that the time spent in education and retraining is increasing and will continue to do so. Dependency ratios calculated on entry into the labour market at the age of 16 are no longer realistic. The government itself plans that a half of each age cohort should in future receive higher education. In the learning society, there will also be spells of further education at later ages. Even if those who study are increasingly obliged to pay for it themselves, they will still not be able to contribute much to pension provision - either their own or anyone else's - during these times.

Another factor that will mitigate the ageing effect is immigration, though existing GAD projections already assume a net inflow of 100,000 a year. Over the course of three or four decades rising immigration has only a mild impact on dependency ratios because the immigrants also have parents, whom they bring over or send money to. The immigrants have fewer children and they, too, begin living longer, all factors conducive to the ageing society. Using immigration as the chief or only way to boost the size of the workforce soon begins to raise population levels to implausible heights.¹⁸ More generally there is a moral issue to be faced. The immigrants accepted by liberalising regimes came from poorer societies, who have paid for the migrants' upbringing and education. It would be wrong for rich societies to plan to meet their pension problems by draining poorer societies of skilled and youthful workers while rejecting the aged and infirm.

Because the birth rate slump has contributed to the ageing of the population, any reversal in this trend would increase future labour supply and, hence, taxes. But the decline in family size has everywhere been a concomitant of prosperity. Britain's birth rate is about average for the developed countries and is accompanied by what the mothers' describe as unwanted births, which official policy seeks to avoid. The measures likely to boost wanted births include better child-care facilities, greater parental leave and shorter and more flexible hours of work – the introduction of the 35 hour week in France has coincided with a jump in the birth rate. These

policies are desirable in themselves. While they might eventually boost the productive population a little they would also demand real resources. They will yield a gain in the quality of life rather than major resources for pension provision - a reminder that spells of 'dependency', whether in youth, old age or in between, are part of the human condition.

With house prices booming, some look to release of the equity value tied up in the family home as a providential answer to pension problems. Once the children have left, many parents find they can trade down to a cheaper dwelling, using the surplus to boost their pension wealth. This species of equity release already occurs and has not availed much for the large number of pensioners living on modest incomes. Those who own valuable houses often have pension wealth anyway, while those who lack good pension coverage often have little housing wealth. Because 'equity release' schemes can so easily give openings to unscrupulous property developers they should only be allowed, if at all, with rigorous safeguards. Older people are often reluctant to move simply to realise equity when this means leaving a neighbourhood where they have friends and family. Finally, and obviously, we cannot assume that the exorbitant property prices of recent times will still be available in 2031.

A Better Citizen's Basic State Pension

If these approaches still leave us with most of the pension deficit to meet where should we look instead? Should we raise NI contributions or general taxes in order to fix the pension provision problem? I believe there is some scope for this, especially in tackling pensioner poverty, but this won't go very far towards raising the target 16.8 per cent of GDP. There is an overwhelming case for improving the basic state pension. Public pension provision is low cost and has a high take up rate. The basic state pension should be paid to all citizens regardless of contribution record. The government has helped to create – in reaction to its own policies - an extraordinary consensus that the basic pension should be dramatically improved, embracing the Conservative Party, the TUC, the House of Lord's select economic committee, the IPPR, Age Concern, the National Pensioners Convention and many others. An improved basic state pension indexed to earnings could largely be financed by boosting the NIC by one per cent of earnings across the

¹⁸ UN Population Division, *Replacement Migration: Is It a Solution to Declining and Ageing Populations?*, New York 2000.

income range. (Gordon Brown won public support for such a rise in 2002 by tying it to increased health spending; boosting the basic pension would enjoy similar legitimacy.)¹⁹

However I think it would be wrong and counter-productive to believe that the wider pension problem should be tackled by further raising what are, in effect, payroll taxes. If the pension gap was mainly to be filled by this method it would mean doubling NI contribution rates. This would take a big bite out of demand, with deflationary consequences, and sharply raise the cost of employment. In continental Europe, where payroll taxes add a 40 per cent wedge to wages, this has contributed to an overall pattern of low demand, low growth and high unemployment. The general level of employment amongst those of working age has lagged some fifteen points below the UK or US figure.²⁰

Similarly there is some scope for raising income tax, perhaps by creating a higher band above £100,000 a year. But there are many public programmes which need better funding – child care, education, health – and so pensions could not be the sole beneficiary. It would be desirable, if it is possible, to find sources of pension finance which do not subtract from what is available for, say, public investment in the learning society or tackling child poverty. As it happens there are, as I hope to show, potential sources of finance for future post-retirement income which meet this demanding criterion. Reaching a level of provision even approaching the overall target of 16.8 per cent of GDP requires more than a decent basic state pension, desirable as that is. It points to a reorganisation of the principles of non-state pension provision, with a dramatic widening of coverage of secondary pensions, the discovery of major new sources of pension finance and a stripping out of the many layers of wasteful expenditure on marketing, customisation, soft commissions, and excessive financial intermediation.

Restoring the Employer's Contribution

At the heart of the pension deficit problem is the dramatic decline in the contribution made by employers, especially private employers. The freezing or closing of Defined Benefit (DB) schemes is a major factor here. More generally corporations practice elaborate tax planning in

¹⁹ For other improvements to the state pension see Bryn Davies, Hilary Land, Tony Lynes, Ken MacIntyre and Peter Townsend, *Better Pensions: the State's Responsibility*, Catalyst 2005. While concurring with the point made by the title of this pamphlet, I will be exploring further ways in which private employers can be obliged to contribute to public provision of better pensions.

²⁰ Andrea Boltho, 'What's Wrong with Europe?', *New Left Review*, No. 22, July-August 2003; Robin Blackburn, 'Eurodenial', *New Left Review*, No. 18, November-December, 2002.

order to reduce the tax take on their profits. Financial engineering and tax havens are an important part of this story. Of course some companies still make a real effort, as do many public employers. But it is wrong to allow the burden to be borne only by the more public-spirited. Corporations themselves depend hugely on the great benefits and privileges they receive from their host society. They benefit from public expenditure on health, education and transport. They benefit from law and order. They enjoy many of the advantages of personhood while being shielded by special legal immunities. All these considerations argue for obliging companies to make a significant contribution to the pension deficit problem. Brendan Barber, the General Secretary of the TUC, has rightly urged that companies should be required to do more: 'Britain needs a bigger pensions pot and tweaking at the edges of a voluntary system is not going to achieve this.'

It would be best if the new source of finance did not add to labour costs since if it did it would encourage unemployment. A tax or levy on assets rather than income would fit the bill. The best-known examples of such taxes are death duties, or a wealth tax. While these are worth considering they have the drawback that in order not to penalise farmers and small businesses exemption rates have to be set quite high. The resulting loopholes allow for mass evasion by the wealthy. As tax advisers put it such taxes are 'optional'. Nowhere do they raise as much as 0.5 per cent of GDP.

An alternative type of asset levy was proposed in Sweden in the 1970s and 80s by the LO, the main trade union federation. It is known as the Meidner scheme after the LO's chief economist at that time, Rudolf Meidner. This levy required all public companies to issue new shares equivalent to five per cent of annual profits each year. The method of assessment was similar to that used for calculating corporation tax but it differed from corporation tax in a crucial respect since it did not make demands on cash flow. Meidner originally wanted the levy to comprise 20 per cent of profits each year and the shares issued under the scheme were to be administered by regional boards on which employees were to be well represented. But the business federations raised an outcry and the Social Democratic government both reduced the levy to about 5 per cent and limited the new issue principle.²¹ Nevertheless the scheme still raised impressive

²¹ See Jonas Pontusson, 'Sweden', in Perry Anderson and Patrick Camiller, eds, *Mapping the West European Left*, London 1994. In Britain capital levies to meet social needs have been canvassed by such eminent thinkers as Sidney Webb, J.M.Keynes, and James Meade, as Martin Daunton explains in *Just Taxes*, Cambridge 2002. . In the 1950s Richard Titmuss and Richard Crossman for a time won the Labour Party over to the idea of meeting secondary pension provision by means of a publicly-controlled, share-holding, social fund – see

amounts of money. Wound up for ideological reasons by the Swedish Conservatives in 1992., the scheme's public investment boards owned 7 per cent of the country's stock market.

An asset levy could help to plug the pension funding gap without subtracting from companies' cash-flow or investment plans. Companies frequently issue new shares - for example, when they negotiate mergers and acquisitions, or when they award share options to executives. The shares raised by the levy could not be sold for five years or more. Instead they would be held to generate revenue in the future when it will be needed to furnish pensions. The future revenue would mainly come from dividend income which is far less volatile than share price. For a considerable time these earnings could be used to buy other securities, including government bonds. In some cases the pension board might be allowed to receive contributions in the form of corporate bonds or cash where that was found desirable.

A public national reserve fund, independent of the government of the day, would be the recipient of the new shares and bonds issued under the scheme. Several countries are now setting up pension reserve funds - Ireland and Sweden are cases in point - and there are obviously a variety of ways of arranging for them to meet pension needs. The new reserve could channel assets from the levy to shore up weak areas of existing provision. It could also establish a new national and regional network of pension funds which would furnish an extra layer of coverage to all. The fund network would have its own staff and specialists, and its directorate would be answerable to individual contributors and beneficiaries.²² (If our European partners agreed it would be possible to include a continental layer to the scheme; this would contribute to tax harmonisation in the Union and help to counteract 'social dumping').

Before spelling out how the network might operate it is worth registering that the British TUC is already committed to exploring a compulsory levy on employers for the purposes of boosting retirement income, albeit that this is not such a detailed proposal as that elaborated by Meidner and the Swedish unions. In its discussion document, *Prospects for Pensions* (2002), the TUC urged that employers be compelled to contribute to pension funds for their employees. The TUC had other important demands - for an earnings-linked state pension, for action to help women and the lower paid and for compensation to those trapped in failing schemes - but the call for compulsory employers' contributions represented a new and dramatic proposal which bears some comparison with the

National Superannuation: Labour's Policy for Security in Old Age, London 1957. See also Richard Titmuss, *The Irresponsible Society*, Fabian Society, 1960. I have more on this in *Banking on Death*, chapter 5.

Swedish trade union plan. In both cases the aim was to ensure that large corporations shoulder some of the burden of the ageing society. The great majority of public employees are already covered by occupational schemes of reasonable quality. Across the private sector coverage is weak and/or patchy – because of the centrality of private corporations in today’s economy it is here that resources can be mobilised to improve provision across the board. The TUC’s proposal concentrates on private employers. It requires them to fund two-thirds of a pension contribution each year starting at just 3 per cent of salary but rising by stages to 10 per cent of salary. Large and medium companies would be encouraged to set up occupational schemes but other employers would make the contribution to an approved scheme such as a stakeholder pension. The low paid would receive a tax credit to assist them to make their share of the contribution.²³ In June 2004 the TUC launched a ‘Pay Up for Pensions’ campaign where it calls for ‘a new occupational settlement based on compulsory contributions from employers’.²⁴

Concerned to re-establish the general principle of employers’ responsibility the TUC did not go into much further detail. The Meidner approach could be seen as simply one way of achieving the goal established in *Prospects for Pensions*. The main difference would seem to be that the TUC is requiring companies to come up with hard cash whereas the Meidner approach allows them to make their contribution in the form of shares or company bonds. It might seem that the cash contribution would be best, though the pension funds would not keep much in the monetary form but would instead buy shares, bonds and other income-yielding assets. The Meidner method would allow the pension funds to build up a highly diversified sample of company shares and bonds; investment income could be used to diversify out of corporate securities by acquiring government bonds and real estate. Companies might find it easier to contribute in shares or bonds rather than cash, but why allow them to do this? The chief reason, briefly touched on above, is that a cash contribution will subtract from the resources available for investment whereas the share contribution would not.²⁵ After properly considering the matter employees as well as employers are likely to see this as a significant advantage. In my view the advantages of the levy approach are likely to be so clear to the parties directly involved that the legislation could allow the exact form of the employers’ contribution - whether cash or new issues - to be agreed by negotiation between them. But the further advantage of the Meidner approach is that it obliges us to move away from two negative features of existing occupational schemes, namely their riskiness and limited portability.

²² By this I mean that a national pension reserve fund would allocate resources to regional pension boards which would manage these funds. Allocations would reflect the size and characteristics of each region’s population.

²³ TUC, *Prospects for Pensions*, May 2002, pp 20-9.

²⁴ For details of this campaign see the TUC website.

Even the best-designed private sector defined benefit schemes have been vulnerable to ‘sponsor risk’, as was noted in a previous section. If the sponsoring corporation goes belly-up then employees will lose out. In the past they could lose everything. With the newly-established PPF (Pension Protection Fund, also dubbed the ‘Partial Protection Fund’) the policy holders will receive some compensation but not the full entitlement. Such DB schemes also deliver the best results only to those who stay with the same company until retirement. These schemes link the future pension to ‘final salary’. If the last salary paid to the member was a decade or more ago then the pension paid will not reflect subsequent inflation and promotion. Much of the advantage of a Defined Benefit scheme is thereby lost. This is much less of a problem in the public sector because most large scale public service schemes allow for a degree of geographical or institutional mobility. But private sector schemes were often designed to promote ‘employee retention’ and exact a penalty from those who leave prior to retiring age. Given the greater fluidity of today’s job market this is a serious drawback. The Meidner-style levy sets up a pension fund and entitlement that is not employer-specific. It is not dependent on the fate of one sponsor and it would be able to offer full portability.

The advantages of universal secondary provision will certainly be greatest for those - the majority of all employees - who currently have no such coverage at all. But those who are in private sector occupational or Stakeholder schemes will be keenly concerned to reinforce and improve their entitlement. Students of pension systems, whether public or private, are prone to stress that they are ‘path dependent’, which is to say that once employees or other contributors have built up an entitlement to a scheme they will be committed to its continuance. In the UK many occupational DB schemes are underfunded, and many of have anyway been frozen, or closed to new members. Defined Contribution (DC) schemes, including Stakeholders, have been let down by the stock market. This conjuncture makes it a bit easier to argue for sweeping changes to the pension system. But it still remains necessary to convince those with a stake in existing schemes that their situation will be improved by any proposed changes. In meeting the problem of those with little or no coverage it would be important to retain the support, and improve the situation, of those already covered.

The TUC supports the case for a better state pension, seeing this as a foundation to build on. Universal supplementary provision could be seen in the same way. Employees in the private sector would be entitled to their fair share of this extra provision, either paid into a supplementary scheme or used to secure and improve their entitlement in any existing occupational scheme. Some shares could go to the proposed new Pension Protection Fund, which is to insure existing DB funds, thus making it possible to reduce cash contributions to this scheme to a level that will cause less strain

²⁵ Of course companies can always raise money from banks or the stock market but, since they don’t exist in a frictionless world, they prefer to finance investment out of their own surplus revenues. In recessionary conditions the need to stump up cash for the pension fund has led to job-shedding as well as slashed investment.

than the £300-600 million currently in prospect. Another portion could go to strengthen existing DC funds. The remainder would fund accountable regional pension boards – either directly elected or composed in part of elected officials - which would offer contributory pensions to all, using residence and citizenship criteria and offering credits to those outside paid employment.

It would be good if every individual over 30 years of age received an annual estimate of the value of their pension savings. In the 2004 Finance Bill the Chancellor introduced a cap on pension wealth of £1.5 million - beyond which no further tax relief would be available - in order to curb the proliferation of retirement schemes and products which secure tax advantages for the wealthy. While the Inland Revenue say that only 5,000 will be affected by the cap in the first instance, with an extra 1,000 a year thereafter, the CBI, the employers' federation, estimates that 10,000 will be caught in the first year and as many as 600,000 could be affected over forty years.²⁶ Hitherto British savers have been able to claim relief from several different types of savings product at once making it difficult to settle this question in advance. But existing pension wealth is certainly very unequally distributed. Despite a spate of government reports we still have no precise map of the distribution of pension entitlements but we do know that in the late 1990s the top 10 per cent of recipients obtained 51 per cent of all pension-related tax relief while the top 20 per cent receive 67 per cent of this relief.²⁷ While the pension reserve fund would channel resources to all pension funds catering to the mass of employees and small savers, those with funds above the upper limit would not qualify.

The regional pension boards could offer basic supplementary coverage to all but encourage employees to save more themselves by offering to match, say, the first £1,000 of annual contributions pound for pound, and a further £3,000 each year at 50p per pound. As with SERPS extra contributions would mean extra entitlement. The matching approach to public subsidy would mean that lower paid workers could be given as big an incentive to save as higher salary earners, removing the regressive features of the present system of tax relief. The existing system of tax relief could also be reduced to a uniform allowance at the lower tax rate, so that richer pensioners lose some of the special tax relief they currently enjoy.

²⁶ Nicholas Timmins, 'CBI calls for change in proposed pension savings restriction', *Financial Times*, 10 March 2004.

²⁷ Gerard Hughes, 'Financing Pensions by Stealth', in Gerard Hughes and Jim Stewart, *Reforming Pensions in Europe*, Cheltenham 2004, pp. 163- 191, p. 182.

My main aim is to identify sources of pension provision and to leave scope for different ways of applying that revenue to pension needs. But I do urge that future pension provision should help to reverse existing extreme and growing inequalities. To this end I would propose that the pension reserve fund would seek to ensure that: (1) all ‘citizens pensions’ would be topped up until they were equivalent to at least a half of median income, adding a ‘defined benefit’ element to the package (2) there would be an income ceiling – at perhaps twice or three times median income - above which the individual would no longer qualify for top ups (3) between these two limits there would be a progressive taper, giving the same absolute amount to everyone, for free, but allowing all to build up extra entitlement if they make contributions of their own.

Two Objections

The asset-levy proposal is likely to encounter a range of theoretical and practical objections. Here are two that merit attention.

Firstly it is often claimed that future pensions must come out of future production, and that this will inescapably mean reducing the remuneration of future workers. The premise is correct but not the conclusion, since it ignores asset-income.²⁸ The new pension funds would hold assets with a strong claim over future income streams, largely at the expense of those with large share holdings. Diluting existing shares by about 1 per cent a year, the share levy would tend to redistribute from the richest 5 per cent of the population to all the net beneficiaries of the new universal pension arrangements. Of course future pension needs might need to be met with some reduction of employee’s future remuneration – which should grow significantly so that the sacrifice would be quite bearable. But in the first instance it is the incomes of wealthy rentiers that should be reined in.

Another line of criticism would urge that the share levy will hurt those with a small stake in shareholdings, including pension funds themselves. Care would have to be taken that all pension funds gain more than they lose from the overall workings of the share levy. But this would not be difficult. Pension funds of all types accounted for 15.6 per cent of ownership of UK public companies at the end of 2002, with insurance funds, some relating to pension provision, holding

²⁸ In an otherwise acute discussion of pension finance Nicholas Barr makes the point about future production but omits non-pensioner asset-holders’ claims on future income. See *The Welfare State as Piggy Bank*, Oxford 2002, p. 149-56.

a further 19 per cent.²⁹ Assuming that all pension funds were in receipt of assets raised by the levy they would be very probably be receiving more than they lost by dilution. However there might be a case for compensating certain pension and insurance funds for any loss of value occasioned by the levy. This would speed up the redistributive process as well as counter a likely source of objection. The funds would simply receive compensation, equivalent to their holdings of shares, as well as their due contribution from the pension reserve fund. The possibility of turbo-charging the levy system in this way might help to deter demagogic attempts to claim that the scheme would not help genuine pension funds.

The pension fund network should also reach out to the small investor, by helping to establish a wider framework of responsible governance – one less at the mercy of over-mighty chief executives and over-ingenious financial officers.

Governance Principles

The regional pension boards could be encouraged to use the voting power of their shares in ways which promoted good corporate governance. At present the commercial fund managers must bear some of the responsibility for the absurd share-price bubble of the late 1990s, for continuing poor governance and exaggerated executive compensation. The pension boards could also carry out their own research, something the commercial fund managers have too often left to self-interested investment banks and finance houses. The network of pension boards, with their own staff and specialists, could push for less extravagant compensation for top executives and financial intermediaries. As knowledgeable and well-resourced transactors, they could help investors generally to acquire more leverage over business leaders and organisations, including the large banks. The funds would have an interest in curbing tax evasion, and, as shareholders, could act as the eyes and ears of the tax and regulatory authorities, just as institutional investors have done with Conrad Black's regime at Hollinger.

In recent years Socially Responsible Investment (SRI) has ceased to be a fringe enthusiasm and has become part of the mainstream – the major exchanges now each offer their own SRI

²⁹ National Statistics release, July 2003. Following the collapse of the share bubble in 2000 pension funds reduced their holdings of shares. According to this release UK individuals, banks and other financial institutions owned 27 per cent of publicly quoted shares while 'foreign' owners accounted for 32 per cent; however British subjects could well be the beneficial owners of many of these 'foreign'-held shares by dint of using overseas tax havens. Insurance companies owned 19 per cent of public shares - a portion of these holdings, perhaps a third, could relate to provision for retirement and might qualify for a rebate.

indexes. The proposed new source of pension finance would mean that the pension network would be in receipt of a stream of shares that would be broadly representative of all companies in the land. Since pension boards would be barred from selling these shares they would not be able to boycott companies whose practices they disapproved of. However, they would be able to 'engage' such companies by using their shareholder power at AGMs and in other consultations. This might allow them, if their members agreed, to discourage anti-social practices - say, the denial of rights to employees, or production processes destructive of the environment. Pension funds are, by their nature, long term investors who have only a tiny portion of their assets in any one company. Their members will be exposed to the negative effects of socially irresponsible practices while benefiting little, or not at all, from them. If pension boards were responsive to the views of members they could well be concerned for the overall health of the economy and its ability to generate returns. But they would be under no compulsion to endorse profitable abuses that can generate short-term out-performance at the expense of the community - since those with pension rights would be the community.

Notwithstanding measures to ensure that all pension funds and small savers benefit from the levy, it is bound to be controversial, because it is re-distributive and because, over time, it will boost the influence of existing 'activist' public sector pension funds. . In the Swedish case the fact that twenty families famously control the bulk of the country's major companies made them particularly apprehensive about loss of control. In the UK and US activist funds already have clout, and responsible managements are learning to live with a new type of institutional investor.

The existence of public, not-for-profit pension suppliers could help raise standards in the pensions industry. The government could also establish more transparency - and stiffer limits - on marketing spend and fees in the commercial sector. A string of scandals and failures – from the pension mis-selling of the 1980s and 1990s to Equitable Life and split-capital funds – show that the authorities have not been good at protecting the interests of savers. Where savings attract generous tax relief the authorities have an even greater duty to ensure that subsidies do not licence waste, greed and unnecessary risk. The Financial Services Authority should end the widespread practice whereby brokers offer 'soft commission' – free business services - in return being awarded trading business. Paul Myners's report singled this out as a practice which makes it difficult, or even impossible, for trustees to properly identify and control trading and research

expenses.³⁰ UK financial costs now loom large enough in the UK to distort UK national accounts. They can be brought down, using legislation, regulation and investor vigilance.

Re-inventing the ‘Social Bond’

Prevailing patterns of private pension provision are bedevilled by undue concentrations of risk as well as exorbitant costs. By itself the Meidner-style share levy could aggravate the problem, since it stems from an over-concentration on one asset class, shares. In the 1980s and 1990s pension consultants were persuaded that pension funds could capture the higher returns that equities offer over the long run simply by holding a diversified portfolio within that asset class. The traditional practice of placing a third or a half of their funds in public bonds to achieve a balanced portfolio was abandoned. As the 1990s progressed, there were anyway very few bonds to buy as the Treasury ran a larger surplus. The demand for public bonds outstripped supply, leading to historically-low yield rates which further encouraged the move to equities.

Government pension legislation not only permitted but, with products like the Stakeholder, actually encouraged, the savings industry to offer products consisting only of shares. Since shares tend to go up and down together the ‘cult of the equity’ carried strong risks, as the roller coaster of 1998-2002 amply demonstrated. Small savers and occupational schemes both suffered. For many low annuity rates compounded the problem of a collapsing market. The poor return on annuities reflects both a continuing dearth of bonds – annuity income is largely generated by bonds – and the high margins charged by providers. Those with personal or defined contribution pensions are also obliged to buy annuities with their pot before the age of 75, despite the fact that the annuities offered by the financial services industry represent very poor value. In 2003 one company, the Prudential, supplied 23 per cent of all the annuities that were purchased. Over the previous five years this company had earned a margin on sales of its annuities of between 42 and 59 per cent, a much higher rate than on any of its other products.³¹ While legislation and regulation could curb such practices the government also needs to ensure that there are suitable inflation-proofed bonds in which savers and pension funds can invest.

The pension network I have proposed could use its cash income from dividends and contributions to purchase assets which offset the risks in its equity holdings. While some funds could be invested in property the network would also benefit if more public bonds were available for purchase. In addition to conventional bonds the government could allow for the

³⁰ (Paul Myners), H.M. Treasury, *Institutional Investment in the UK, a review*, March 2001, pp. 95-6.

establishment of a new type of social or people's bond guaranteed not directly by the Treasury but indirectly by the capital spending of publicly-funded education, health and transport services. The money raised by the sale of these infrastructure bonds would finance the needed capital construction and the end users would enter into a twenty or thirty year hire-purchase agreement with respect to the facilities so constructed. This is not the place to spell out all the ways in which the bonds could be organised. But according to one detailed proposal such infrastructure bonds would be offered by not-for-profit institutions akin to building societies whose skilled staff would put the construction projects out to tender.³² In effect the new people's bonds would take the place of the costly PFI (Private Finance Initiative) and PPP (Public-Private Partnership) agreements which have been used to raise money for capital investment in schools, hospitals, transport and other public programmes. If public institutions are to enter binding agreements to make a stream of payments to a financial institution then it would be best if deserving recipients like pension funds were to be the beneficiaries. Since pension funds take in about £50 billion in contributions each year they would certainly have the needed resources. Only bona fide pension funds would be allowed to buy or sell the social bonds. After the bruising experiences of recent years most pension funds would welcome the opportunity to diversify by purchasing high grade social bonds. Pension fund members would also be pleased to subscribe, via their contributions, to needed public infrastructure. Indeed while such bonds would improve pension funds' asset balance they could well do even more to boost the regeneration of public infrastructure. Small savers could also be given the opportunity to invest in such instruments and they could figure prominently in an annuity portfolio. The social bonds would offer an attractive way to invest pension fund contributions and might therefore persuade many to contribute somewhat more than would otherwise be the case. The eventual yield on the bonds would replace what might otherwise be spent on servicing and redeeming loans from the private sector. It would be more secure than a commercial investment but the yield might be a little lower, as with a government bond. This approach will offer a good way of investing pension money; and is not chiefly designed to boost pension revenue, though it might do so by raising the rate of savings and by cutting the costs of financial intermediation.

Can We Plug the Gap?

³¹ John Plender, 'Milked at 75', *Financial Times*, 5 April 2004.

³² See Richard Murphy, Colin Hines and Alan Simpson, *People's Pensions: New Thinking for the 21st Century*, New Economics Foundation, February 2003. These authors suggest that the rate of interest would be set between a government bond, on the one hand, and the higher rates received by banks that subscribe to PFIs (Private Finance Initiatives) or PPPs (Public-Private Partnerships) on the other. They also discuss ways in

I started by insisting on the future pension funding gap. Could the approaches I have outlined fix the pension deficit? By itself the share contribution scheme I have outlined would be helpful but not a 'magic bullet'. There is no magic bullet. But every little helps. The UK corporation tax, levied at 30 per cent is likely to raise about £35 billion in 2005-6, a level already reached in 2000-1. If the share levy was set at 10 per cent of profits, it would, after allowing for rebates, raise £10 billion annually. If all shares issued to the pension reserves were held to 2031, with re-investment of earnings, then a fund of £700 billion could be built by that date. I assume here that profits grow in line with GDP at 2.5 per cent a year., and that the fund will achieve 5 per cent annual growth. If contributions raised by the matching funds device yielded a further £300 billion, then the total fund would be worth £1 trillion by 2031. If the fund then adopted a pay-out rate of 4 per cent of its total value it would be able to pay out £40 billion annually, equivalent to 2 per cent of GDP, which would have roughly doubled by that time.³³ Where would the rest come from? I have above supported raising national insurance contributions across the range by 1 per cent, which should yield close to 0.8 per cent of GDP. Reducing tax relief on pension plans could raise 1 per cent of GDP. Private pensions currently supply about 4.0 per cent of GDP; this might be raised to 5.5 per cent with cost reduction in the financial sector and the availability of more suitable assets, such as inflation-proofed bonds and social bonds. A well-managed economy, combined with the eradication of age discrimination, could raise the number of the over-65s who find work, without resort to the regressive expedient of a higher state pension age. About 8 per cent of those over the state pension age work today and this proportion could be raised to 12 or 15 per cent. The remuneration of the older worker could add a further 1.5 per cent of GDP to meet the income needs of those over 65. State provision – not including the 0.8 per cent boost already mentioned – is expected to be between 4.7 per cent (according to the DWP) and 5.5 per cent (according to PricewaterhouseCoopers). Add these all together and we have a total of between 15.5 and 16.3 per cent of GDP, so either 1.2 per cent or 0.5 per cent short of what is needed if we were to maintain the same ratio between earned income and pensioners' incomes as we have today. For the moment I will have to leave this as an continuing challenge.

which the people's bonds could be structured to reinforce the Second State Pension. In *Banking on Death*, on pp. 338 and 492, I have a much less detailed discussion of the need for assets of this type.

³³ UK GDP growth was 2.6 per cent a year between 1990 and 2003. While I believe that the new regime will enhance the ability of the tax authority to discover profit I have made no allowance for this. The year 2031 is an appropriate benchmark because the ageing effect will by then have reached a new level. I have a similar computation for the US in 'The Pension Crisis and How to Tackle It', *Challenge*, July-August 2004.

I concede that the measures I propose have a sweeping and radical character. But I doubt that anything much less will suffice to tackle the simultaneous crisis of public and private pension provision we now face. In my view robust proposals for reform should help us to pay decent pensions not furnish excuses for removing pension rights to which many have contributed all their lives.

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